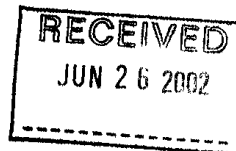




COMMISSIONER

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

June 18, 2002



MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: *Acting for* Charles O. Rossotti *Bohnenz*
Commissioner of Internal Revenue

SUBJECT: Draft Management Advisory Report – The Internal Revenue Service's Response to the Falling Level of Income Tax Examinations and Its Potential Impact on Voluntary Compliance (Audit # 2001-30-039)

I reviewed the draft management report, and I agree with your assessment of the declining examination coverage rates from Fiscal Year 1997 to 2001, and the ongoing efforts by the Internal Revenue Service (IRS) to serve our taxpayers more efficiently. As mentioned in your report, the Congress and other stakeholders are concerned about our declining examination coverage rates and its potential effect on voluntary compliance. As the research findings show, there appears to be a strong correlation between examination coverage rates and voluntary reporting compliance.

As indicated in your report, both Large and Mid-Size Business and Small Business/Self-Employed continue to analyze their processes and procedures to identify ways to improve the efficiency and effectiveness of our examination programs. By the end of FY 2003, we will have completed the reengineering of our SB/SE Examination processes. A key component of the SB/SE Examination reengineering effort involves an enhancement of our return selection system in order to reduce taxpayer burden by focusing our resources on the most non-compliant returns generally by issue(s).

Traditionally, our field examination work plans were developed by return type and activity code. Starting in FY 2003, future examination work plans will be developed around specific non-compliance issues.

- Understatement of business income
- Abusive Tax Schemes (including Abusive Trusts, Off-shore Activity, and Domestic Promotions)
- Non-filing

- Use of flow through entities (Partnerships/S Corporations) by high income taxpayers to create structured transactions designed to reduce or eliminate tax liability
- Industry Issue Resolution Program

In FY 2001, we protected revenue of \$3 billion through the Frivolous Return Program by stopping refund claims before they were paid. We are capturing data from 16.8 million K-1 schedules to match against tax returns to help us identify non-compliance and follow up with examinations where appropriate. We increased our taxpayer education outreach efforts in the area of tax schemes and abusive tax shelters through the issuance of notices, use of press releases, our Internet Web site, and by networking with outside stakeholders.

The following are our specific comments on your recommendations:

The Commissioners of the LMSB and SB/SE Divisions, who have the overall responsibility for most of the IRS' examination resources should:

RECOMMENDATION 1

Accelerate their implementation of an examination strategy focusing on issue management, rather than the current return-based approach, for income tax examinations in the Non-CIC and Office Examination Programs.

ASSESSMENT OF CAUSE

The current lack of national guidelines or direction for determining the scope of examinations in the Non-CIC programs, results in every examiner applying their own measure of materiality to each case. This inconsistency does not promote fairness of our tax administration system.

CORRECTIVE ACTION

A key weakness of our current Non-CIC return selection process is the inability of Discriminant Function (DIF) to identify returns with a high potential for unreported income and to identify other specific issues with potential noncompliance. Almost 60 percent of the gross individual income and employment tax gap for SB/SE taxpayers arises from the understatement of business income (which reflects both the underreporting of gross receipts and the overstatement of business expenses).

SB/SE and the Office of Research recently completed testing of new Unreported Income DIF formulas (UIDIF) that were designed specifically to identify returns with a high probability of unreported income. The higher the UIDIF score the greater the probability of unreported income. The UIDIF formula creates a new work stream for SB/SE field examination.

In SB/SE and LMSB our return classification and selection processes will be nationally controlled. The classifier will determine which returns will be audited

and what issues will comprise the initial scope of the audit. Examiners will use a risk-based approach and materiality guidelines to make a "Go/No Go" decision on pursuing additional entities or issues during an examination.

The SB/SE Examination reengineering effort also introduces new inventory management practices and enhanced auditing procedures and techniques that will further improve the quality and timeliness of our examinations.

In LMSB, our Industry Issue Resolution (IIR) Program has made significant progress in several key industries and areas. The issues under consideration have historically presented several challenges on very large cases that, if completed under this Program, will give our field and taxpayers guidance on future filings.

Our Pre-Filing Agreement (PFA) Program shows equal promise and has recently been expanded to include taxpayers in SB/SE. We can address problematic issues earlier on a case-by-case basis. This strategy provides a clear method to resolve issues early and allows our workforce to concentrate on returns worthy of our limited examination resources.

The Post-Filing Design Team processes will allow us to better focus on issue management in our industry cases (Non-CIC). We shared several of these processes with external stakeholders and we continue to consider their input in the design of issue management strategy.

We implemented objective scoring models for industry cases and changed the traditional classification for LMSB cases. We are not using classification check sheets, which were once common in all cases. In addition, we are using the qualified judgment of our experienced employees and managers to perform the correct risk analysis of cases.

In addition, the LMSB and SB/SE Divisions are reemphasizing and expanding the use of the Examination Operational Analysis Database (EOAD). This database will help us gather data on issues related to our industry case population and other specific issues.

IMPLEMENTATION DATE

Ongoing

RESPONSIBLE OFFICIALS

Director, Compliance Policy, SB/SE

Director, Strategy, Research, and Program Planning, LMSB

CORRECTIVE ACTION MONITORING PLAN

Pilot programs will be conducted in field and correspondence examination during FY 2002 and 2003, to collect data to support a national rollout for the

examination redesign effort. A set of data elements were identified to demonstrate the impact SB/SE reengineering will have on examination business results. Relevant business results data will be extracted from the Audit Information Management System (AIMS) and combined with additional pilot specific data provided by the participating groups.

RECOMMENDATION 2

Develop a business results component of their respective "Balanced Measures" that indicates the impact examinations are having on voluntary tax reporting compliance.

ASSESSMENT OF CAUSE

We do not have an indicator that calculates the impact of examinations on voluntary reporting compliance.

CORRECTIVE ACTION

We disagree with this recommendation. While we concur that an accurate statistical measure of the long-term effect of examinations on voluntary compliance would be valuable to the IRS in work planning and the allocation of resources, such a measure would be difficult to implement for the following reasons:

- To track any long-term effect of an examination would require repeated examination of a select group or groups of taxpayers. We could assume that only those taxpayers that we examine would be familiar with the activity and results of the examination, and so react by becoming more or less compliant. Measuring the long-term effect of the examination on voluntary compliance would require targeting the group for repeated examination. Such targeting would be inconsistent with our commitment to fair treatment of all taxpayers.
- Other factors, such as income level, source of income (wages, self-employment, investment), level of tax knowledge, education level, language barriers, and ability to pay could have a significant yet unmeasurable impact on the future compliance effect of an examination. The examination and monitoring of a particular group may not have the same or any compliance impact on another group.
- Although income tax examination coverage has declined in numerical terms, we have taken steps to retain the positive influence the process has on voluntary compliance. The Examination Reengineering Project, now in progress, uses a variety of information sources to select those returns that we expect to contain errors. In addition, examinations are better oriented to areas noted for non-compliance in particular taxpayer occupations. We expect these improvements in the examination process to more effectively use our limited resources to detect tax deficiencies and foster voluntary compliance.

IMPLEMENTATION DATE

Not Applicable

RESPONSIBLE OFFICIAL

Not Applicable

CORRECTIVE ACTION MONITORING PLAN

None

RECOMMENDATION 3

Jointly or separately, conduct a study across all income tax return classes to determine the indirect effect that income tax examinations have on amounts voluntarily reported. The study design should include information to determine taxpayer responses to issue management examinations rather than to full return examinations.

ASSESSMENT OF CAUSE

Not Applicable

CORRECTIVE ACTION

The Director, Research, Analysis, and Statistics (RAS) generally concurs with the TIGTA recommendation that it would be worthwhile to conduct further studies of the indirect effects of examinations on voluntary compliance. As noted in the report, we have conducted a few studies over the years, one of which was based on a senior economist's doctoral dissertation (*The Determinants of Individual Income Tax Compliance: Estimating the Impacts of Tax Policy, Enforcement, and IRS Responsiveness*, IRS Publication 1916, Rev 11-96).

In 1998, the Office of Research contracted with Price Waterhouse to conduct a consensus judgment study with senior IRS operations executives to develop estimates of the relative indirect effects of various IRS programs and activities (*Consensus Estimates of Indirect Effects*, April 10, 1998). Since that time, the Office of Research has concentrated on the application of indirect effects relative to direct effects in the Service's resource allocation decision making process. It is the intent of RAS to update and increase our knowledge of indirect effects (to the extent possible) through future studies.

However, for the foreseeable future, it will be very difficult, if not impossible to compare indirect effects of taxpayer behavior from issue management examinations with full return examinations as suggested by TIGTA. Research on the indirect effects of compliance activities is still in its infancy. Furthermore, the data available in the near term will reflect traditional examinations. Sufficient data reflecting results from issue management examinations will not be available for some time.

Moreover, we cannot measure the indirect effect from any particular taxpayer contact. Instead, indirect effects can only be estimated approximately by comparing estimated variations in compliance levels over time and among broad geographic areas with variations in total IRS exam resources across the same years and regions.

Variation in compliance, in turn, cannot be directly observed. These variations can only be approximated by comparing changes in reported income and deductions from tax returns with changes in comparable measures from economic survey data. For this reason, we could only get useable estimates of the relative return to issue management examinations if we could observe differences in the level of such examinations compared with traditional examinations over a number of years and across different regions and then associate these changes with estimated changes in compliance. Obviously, this requires a sustained long-term effort to capture the relevant data for future analysis.

We believe that it would be worthwhile for RAS to update and improve estimates of indirect effects, however, we do not believe it would be worthwhile to devote large amounts of resources in the near term in an effort to develop estimates at a level of detail that available data will not support.

IMPLEMENTATION DATE

Not Applicable

RESPONSIBLE OFFICIAL

Not Applicable

CORRECTIVE MONITORING PLAN

Not Applicable

RECOMMENDATION 4

Continue to obtain stakeholder input to help develop techniques to make issue based examinations less intrusive and time consuming.

ASSESSMENT OF CAUSE

Prior to the passage of RRA '98, we used a series of productivity indicators to measure the success of its examination program. These indicators emphasized achieving numeric targets and did not adequately consider the impact on quality casework, fair treatment of taxpayers, and employee satisfaction. As such, we did not consider stakeholder input in conducting our examinations.

CORRECTIVE ACTION

After the passage of RRA '98 and at the inception of our modernization program, we emphasized the Customer Satisfaction component of our balanced measurement system. This component requested feedback from taxpayers to

assess how satisfied they were with the Examination process. We received this feedback through a Customer Satisfaction Survey and share the data with the business units to determine appropriate action. The information we receive from stakeholders has helped us reduce taxpayer burden, offer untraditional hours for examinations, (tested in Office Examination in El Monte and Brooklyn local offices), and improve written communications with taxpayers. This effort is ongoing.

The Office of Taxpayer Education and Communication (TEC) in SB/SE has proactively responded to stakeholder concerns. TEC developed a web-based Issues Resolution Tracking System to help monitor the resolution of issues identified by stakeholders. The tracking system will help detect issues that cross areas and can be worked at the Headquarters level. This database will also contain issues raised by stakeholders during outreach activities, phone calls, meetings, etc. and will be used to proactively respond to and monitor stakeholder concerns. Other activities include:

- Holding monthly meetings with stakeholder groups to gather input from their members
- Developing partnerships to encourage easy and effective dialogue
- Monitoring SBREFA hearings to gather taxpayer input
- Monitoring Taxpayer Advisory Panels to identify issues
- Briefing stakeholders on the National Research Project

The primary goals of the SB/SE Divisions examination redesign effort were to reduce taxpayer burden, standardize the use of best practices by private industry and government agencies, and to increase effectiveness and timeliness in examining returns and resolving taxpayer issues. During the baselining phase of the project, team members conducted dozens of internal and external interviews to determine stakeholder views of the current audit process. The information obtained from these interviews was considered in our redesign efforts.

The LMSB Division has involved stakeholders in the design process by collecting their input in developing techniques for issue-based examinations that are less intrusive and time-consuming. Their issue management initiatives are intended to gather extensive stakeholder input. Trade groups and other industry representatives are key players in developing agreements and field guidance that reduce case time by resolving issues early.

Furthermore, the Post-Filing Design Team continues to share their processes with external stakeholders and to consider their input in the design of the issue management strategy and processes. This ensures a common understanding of

our goals and objectives. As a result, we are able to reduce case time and focus on significant areas of concern.

IMPLEMENTATION DATE

On-going

RESPONSIBLE OFFICIAL

Director, Compliance Policy, SB/SE

Director, Strategy, Research and Program Planning (SRPP), LMSB

CORRECTIVE MONITORING PLAN

Not Applicable

If you have any questions, please call Joe Brimacombe, Deputy Director Compliance Policy, Small Business/Self-Employed, at (202) 283-2150.